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SUBJECT: PARAGUAY'S PLAN TO FORMALIZE CDE

REF: ASUNCION 423

SUMMARY

¶11. The GOP has announced a new tax plan designed to help formalize the economy of Ciudad del Este, situated on the border with Brazil. The system will be voluntary and is expected to take effect in November. Participants will receive benefits such as lower tariffs and lower up-front tax payments upon importation. In return, participants must commit to claiming the full value of imported merchandise, sharing financial information to allow for verification that purchase prices match declared values, and the collection of customer data. The GOP expects to increase revenues with the plan, while minimizing opportunities for corruption. Pitfalls abound: Customs is unsure how to implement the decree, and businesses are concerned about the potential for harassment from prosecutors for past practices. USAID-funded Paraguay Vende played an important role in the development of the plan. The initiative is another example of the political will to push forward with economic reforms. End Summary.

A STEP TOWARD FORMALIZING CDE

¶12. On September 15, Minister Bergen invited the Ambassador to a private briefing on the GOP's plan to create tax and other incentives to formalize the economy in Ciudad del Este, Paraguay's second largest city located in the tri-border area. The Director of the Tax Administration, Andreas Neufeld, and Vice Minister of Economy Jorge von Horoch also attended the briefing, as did Econchief. Minister Bergen briefed the Brazilian Ambassador separately the same morning, with the rationale that Brazil is the largest market for information technology products sold in CDE, and the United States is the largest provider of those products. After three months of low profile work, largely based on a study as well as the promotion of dialogue by USAID-funded Paraguay Vende, Neufeld announced the initiative to the public on September 19, with an expected implementation date of November 1.

CREATING THE RIGHT INCENTIVES

¶13. The initiative has two basic principles: firms will have to sign up and commit to certain actions that will facilitate enforcement in order to qualify for the benefits of lower taxes, and the new rates and rules should minimize incentives to cheat or pay bribes. It was designed with two constraints in mind: the GOP must collect at least the same amount under the new regime (Paraguay depends heavily on customs revenues), and it must be entirely consistent with Paraguay's obligations under Mercosur.

¶14. The program, which is supposed to take effect in November, will technically apply to all items covered under Paraguay's Tourism Regime, which includes information technology and telecommunications equipment (IT), electronics, perfumes and other luxury items. Initially, however, the GOP anticipates heavy IT participation eventually leading others to join. The GOP will take advantage of a special Mercosur preference that allows Paraguay to charge a zero tariff on IT products through the end of 2005, after which the tariff will return to the current level of two percent.

¶15. The plan includes a few fundamental changes. First, most tourism regime goods have hitherto been exempt from the value added tax (VAT), which runs ten percent on most goods. Beginning with implementation of the new tax regime, though, all sales of these items throughout Paraguay, to Paraguayan citizens, will be subject to the ten percent VAT. Sales to

foreigners will be exempt. Importers who sign up for the new regime will only be charged an advance of 1.5 percent of the 10 percent VAT, with the balance (on sales to Paraguayans) to be collected later. In practice, though, most sales are to foreigners, and importer sales to distributors would not trigger the VAT, meaning that the 1.5 percent will be the final VAT for most importers. Importers who choose not to sign on will be charged the entire ten percent up front upon importation of the merchandize, thus providing an incentive for importers to register.

¶ 16. Second, advance collection of income tax by customs will be reduced for participants from three percent to 0.3 percent, with the balance collected later. Vice Minister Neufeld considered this change to be fundamental. The ability to offset future income tax liability creates a strong incentive for businesses to justify their expenses: by demanding legal receipts from suppliers, registering workers, etc. The current system collects all taxes in advance, leaving little or no incentive to operate legally. In comments to the press after the September 19 announcement, Neufeld said he expected tax revenues to increase, both through a higher volume of merchandize and through the increased VAT collections.

BREAKING THE CYCLE OF CORRUPTION

¶ 17. Neufeld provided a side-by-side comparison of the taxes paid by a firm undervaluing a shipment by 50% but paying taxes under the current system, and the taxes paid by a firm declaring the full value of a shipment under the new system. The tax paid under the new system for a \$1,000 importation would be \$18.25 versus \$26.00 under the current system, even with undervaluation. The \$26.00, though, does not include the additional costs of bribes to facilitate the undervaluation in the first place. Neufeld also pointed out that minimizing taxes collected upon importation also minimizes the potential savings to be had by paying a bribe to avoid those taxes.

¶ 18. To guard against fraud in the new system, participants must agree to report all financial payments and explicitly link those payments to particular imports. The goal is to verify declared values of imports by checking that outgoing financial transfers match the declared values. If transfers exceed declared values, one would suspect undervaluation. The GOP intends to police the new arrangement by relying on the cross-referencing of taxpayer customs, tax and financial data, with the vetted tax crime investigative unit being developed with help from Treasury's Office of Technical Assistance (OTA) having primary responsibility.

¶ 19. The plan was developed in close consultation with municipal authorities and the portion of the local private sector in CDE that wants to formalize (i.e., pay taxes and compete honestly and legally). USAID-funded Paraguay Vende played an important intermediary role that included the publication of a study on real business practices in the IT sector on the border which provided a neutral assessment as a basis for designing the initiative. Bergen explained that while they know the plan is not a panacea, they see it as an important first step toward the formalization of CDE's economy. He said he fully expects to be attacked, perhaps indirectly and in the press, by those interests that will be negatively affected.

BERGEN REQUESTS HELP - TTU FITS THE BILL

¶ 10. Since the US is the primary source country for IT products imported into Paraguay, Bergen asked the Ambassador for help with either providing specific valuation information for particular shipments (to cross-reference with the declared values upon entry into Paraguay), or with independent reference values. Bergen was concerned that if the GOP itself devised a list of reference values, it would be accused of being arbitrary, whereas if values came from the U.S. or elsewhere, it would be more transparent and defensible. Post's Resident Enforcement Advisor is looking into the request.

¶ 11. The Ambassador explained that the Department of Homeland Security is working with Paraguayan Customs to establish a vetted Trade Transparency Unit (reftel) that would be able to share container-level valuation information as reported upon export from the US. Neufeld said such data would be a great help, even if a few months behind real time.

POTENTIAL PITFALLS ABOUND

¶12. Several pitfalls await implementation of the initiative. Sacrificing inclusiveness for secrecy, Tax Administrator Neufeld did not include Customs in the planning process. In a September 27 meeting, the Customs Director told USAID that Customs was unsure how to implement the initiative, and lamented that Customs had not been brought into the planning process earlier.

¶13. USAID-funded Paraguay Vende worked with the IT Chamber of Commerce for several months studying how to design the regime specifically for that sector so that it could be both formal and competitive. At the last minute, the GOP decided to issue a general decree applying to all tourism regime items, instead of starting with the IT as originally expected. Paraguay Vende personnel worry that the lack of analysis of the competitiveness of other sectors could lead to implementation problems.

¶14. Finally, both members of the IT sector and Paraguayan Customs are concerned about their vulnerability to harassment from prosecutors since the Presidential decree that was signed does not provide immunity for participants for past business practices. In theory, prosecutors could develop legal cases against participants who suddenly change the valuation of their products (i.e., declare the full value), after years of under-valuation. Neufeld told the DCM that he had briefed the new Attorney General, who agrees that they will not/not prosecute those who come clean. He said he understood the desire of some to have formal guarantees against prosecution, but said that would set a bad precedent and undermine the rule of law. Companies legitimately formalizing would not face problems, he added, but there would be no amnesty.

COMMENT

¶15. The plan could work, and is another demonstration of the political will of Minister Bergen and his team to formalize Paraguay's economy. President Duarte spoke for an hour at the announcement ceremony about the importance of formalizing and modernizing the economy. The planned TTU fits in perfectly with the new initiative, which, if successful, would make it easier to identify and counter the criminal elements operating in CDE involved in piracy, money laundering and terrorism finance. Time will tell if the significant pitfalls that await implementation are enough to derail the initiative.

KEANE